82-1811

No. ____

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DESERT PALACE, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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May 6, 1983

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QUESTION PRESENTED

Under the decisions of this Court and longstanding Treasury Regulations, an accrual-basis taxpayer must recognize income "when all the events have occurred which fix [his] right to receive [it]." Treas. Reg. § 1.446-1(c)(1)(ii). The question presented is whether a taxpayer has a "fixed right" to receive income represented by an obligation that is absolutely void under state law and thus legally unenforceable against the obligor.

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Desert Palace, Inc., petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court (App. A, *infra*, 1a-21a) is reported at 72 T.C. 1033 (1979). The memorandum of the Court of Appeals (App. B, *infra*, 22a-23a) is not officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on December 30, 1982 (App. B, *infra*, 22a). Petitioner did not seek rehearing in the Court of Appeals. By order dated March 15, 1983, Justice Rehnquist extended the

time for filing a petition for a writ of certiorari to and including May 6, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of sections 446 and 451 of the Internal Revenue Code of 1954 (26 U.S.C.) and of sections 1.166-1, 1.446-1, 1.451-1, and 1.461-1 of the Treasury Regulations on Income Tax (26 C.F.R.) are set forth in App. C, *infra*, 24a-25a.

STATEMENT OF THE CASE

1. Petitioner, Desert Palace, Inc., operates a licensed gambling casino in Las Vegas, Nevada. In the normal course of business, petitioner extends credit to some of its customers. A customer obtains credit, in the form of chips or other medium of exchange, by signing an IOU or "marker," which resembles a countercheck. During the tax years in question, between 22% and 30% of petitioner's gambling receipts were represented by IOU's. (App. A, *infra*, 4a). Petitioner does not charge interest on its outstanding IOU's, nor are they secured. (App. A, *infra*, 10a).

Gambling IOU's under Nevada law are absolutely void and thus legally unenforceable against the obligor. *See, e.g., Sea Air Support, Inc.* v. *Herrmann*, 613 P.2d 413, 414 (Nev. 1980) (holding that pursuant to common law, as modified by the Statute of 9 Anne, c. 14 § 1, gambling debts are "utterly void, frustrate and of no effect"). Gambling debts incurred in Nevada are likewise unenforceable in every other State. (App. A, *infra*, 18a (citing cases)). They are unenforceable even against a holder in due course. *Sandler* v. *District Court*, 614 P.2d 10 (Nev. 1980).

2. Petitioner uses the accrual method of accounting for tax purposes. Under that method, petitioner treats its winnings from gambling credit transactions as income in the tax year in which the IOU's in question are actually paid. Under Treasury Department regulations, an accrual-basis taxpayer is not required to include an amount in income until "all the events have occurred which fix the right to receive such income." Treas. Reg. § 1.451-1(a). Because gambling debts are void and legally unenforceable, petitioner believes that it has no "fixed right" to receive income from credit transactions until the IOU's are in fact paid. IOU's that remain unpaid at the close of a year are included in taxable income for the year in which payments, if any, are received. (*See* App. A, *infra*, 13a-14a).

3. For financial accounting purposes, petitioner treats its winnings from gambling credit transactions as income at the time the transactions take place. This is consistent with financial accounting principles. They provide that "profit is deemed to be realized when a sale in the ordinary course of business is effected," so long as collection of the sale price is "reasonably assured." AICPA, Accounting Research Bulletin 43, ch. 1A, ¶ 1 (1982). Based on its collection experience, petitioner believes that the gambling IOU's satisfy this standard. (App. A, *infra*, 11a).

4. On audit, the Internal Revenue Service maintained that, for tax purposes as well, petitioner must recognize income from gambling credit transactions when the transactions take place, rather than when the IOU's are paid. The Service accordingly increased petitioner's taxable income for the years 1966-1969 by $9,568,185.

The Service's proposed deficiency was not based on the proposition that gambling debts create a "fixed right" to income under the "all events" test. The proposed adjust-

ment, rather, was based on a so-called "two step transaction" theory of gambling operations. The Service reasoned that a customer's purchase of chips on credit was a separate transaction from the gambling transaction in which the casino won the chips back; the casino was said to earn income when it won the chips, regardless of whether the customer happened to have financed his gambling by paying cash, by borrowing from the casino, or by borrowing from a bank. Relying on the "two step transaction" theory, in short, the Service contended that the voidness of gambling IOU's was irrelevant to the question of whether a casino realizes income when its patrons lose borrowed chips. (App. A, *infra*, 19a-20a).

5. Petitioner sought redetermination of the deficiency in the Tax Court. The Service in its principal brief stated that it was relying exclusively on the "two step transaction" theory. After a hearing, the Tax Court requested supplemental briefs addressed to the following question:

> If the Court should reject respondent's theory that the [IOU's] may properly be disassociated from the gambling transactions whereby the borrowed money was lost, should the taxpayer nevertheless be required to accrue the amounts represented thereby as income prior to the receipt of payment?

(App. A, *infra*, 18a). The Government replied by conceding that, if the Tax Court were to reject its "two step transaction" theory, petitioner "should not be required to accrue the amounts represented [by] casino accounts receivable as income prior to the receipt of payment." (App. D, *infra*, 27a). Specifically, the Government stated (App. D, *infra*, 27a):

> Legal enforceability of casino receivables is a necessary ingredient in determining when the petitioner's right to receive gambling income is fixed within the

> meaning of Treas. Reg. § 1.446-1(c)(1)(ii). Under an accrual method of accounting, income accrues only when all the events have occurred which fix the taxpayer's right to receive such income. *United States* v. *Anderson*, 269 U.S. 422 (1926); *Spring City Co.* v. *Commissioner*, 292 U.S. 182 (1934). The unenforceability of the gambling debts receivables [sic] affects the accrual of income in that it presents a contingency which precludes accrual of income under the all events test of Treas. Reg. § 1.446-1(c)(1)(ii).

The Tax Court did reject the Service's "two step transaction" theory and, based on the Government's concession, held that gambling IOU's "do not represent accruable income until paid." (App. A, *infra*, 20a).

6. The Government appealed to the Ninth Circuit. While the appeal was pending, the Ninth Circuit issued its decision in *Flamingo Resort, Inc.* v. *United States*, 664 F.2d 1387, *cert. denied sub nom. Hilton Hotels Corp.* v. *United States* (No. 82-404), 103 S.Ct. 446 (1982) (App. E, *infra*, 29a-36a), holding that the voidness of gambling debts is not a contingency sufficient to preclude a casino's accrual of income under the "all events" test. The Ninth Circuit in *Flamingo* reasoned that "the existence of a legal liability to pay is [not necessarily] a prerequisite to the existence of a 'fixed or unconditional right' to receive payment," and that accrual of income for tax purposes " 'depends not so much . . . upon the legal right to enforce collection as upon the existing probability of its being received.' " (App. E, *infra*, 33a, *quoting Barker* v. *Magruder*, 95 F.2d 122, 123 (D.C. Cir. 1938)). The Ninth Circuit held that its decision in the instant case was controlled by *Flamingo* "for the reasons stated in that opinion." (App. B, *infra*, 23a).

REASONS FOR GRANTING THE PETITION

This case presents an important question concerning the timing of *both* income *and* deductions under the

accrual method of tax accounting. This Court has repeatedly held that tax accounting, unlike financial accounting, demands *certainty*. A fundamental principle of tax accounting—reflected in decisions of this Court and in Treasury Regulations construing the "all events" test—is that estimates or predictions of revenue and expense are irrelevant in computing taxable income. The decision below departs markedly from this fundamental principle. It requires petitioner to accrue the income represented by a void and unenforceable obligation simply because there exists at year end "a reasonable expectancy" that the debt will ultimately be paid.

The new test for accrual advanced by the Ninth Circuit ignores decades of established law and jeopardizes millions of dollars in tax revenues. It invites taxpayers to apply a "reasonable expectancy" standard in accruing deductions as well as income. Left unreviewed, it threatens to reopen the issue, previously decided by this Court, as to whether reserves for estimated expenses are accruable deductions for tax purposes.

Several months ago, this Court denied certiorari in *Flamingo Resort*, *supra*, a case that presented a question substantially identical to that presented here. Because of the broad significance of this issue and its potentially devastating effect on federal tax revenues, the question should be considered by this Court. This case presents an appropriate vehicle for such consideration.

DISCUSSION

1. The Decision Below Conflicts With This Court's Decisions And With Treasury Regulations Requiring A "Fixed Right" Or "Unconditional Obligation" As The Basis For Accrual Under The "All Events" Test.

This case presents an important question concerning construction of the "all events" test, one of the most

frequently recurring concepts in tax law. The "all events" test governs the timing of income and deductions for all taxpayers (including most of the nation's businesses) that use the accrual basis of accounting. The test has two elements, both of which must be satisfied before accrual is proper. First, all the events must have occurred which "fix the right to receive income" or "establish the fact of the liability giving rise to [a] deduction." Treas. Reg. § 1.446-1(c)(1)(ii). Second, the amount of income or deduction must be "determin[able] with reasonable accuracy." *Id.* The second element is concededly satisfied here. This case concerns the first element of the "all events" test—the circumstances that establish a "right to income" or a "fact of liability."

The "all events" test had its genesis in *United States* v. *Anderson*, 269 U.S. 422 (1926) (accrual of deductions), and *Spring City Foundry Co.* v. *Comm'r*, 292 U.S. 182 (1934) (accrual of income). In *Spring City* this Court declared that "it is the *right* to receive . . . that determines inclusion of [an] amount in gross income. When the right to receive an amount becomes fixed, the right accrues." 292 U.S. at 184-85 (emphasis original). A "fixed right" to receive income, in turn, presupposes an "unconditional liability" to pay on the part of the obligor. *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 13 (1930). The "fact of liability" is not established if the obligor's duty is "contested and uncertain." *United States* v. *Safety Car Heating Co.*, 296 U.S. 88, 93-94 (1936). These cardinal principles of tax law, firmly rooted in this Court's decisions, have been codified in Treasury Department regulations for 25 years. *See* Treas. Reg. §§ 1.446-1(c)(1)(ii), 1.451-1(a), 1.461-1(a)(2) (App. C, *infra*, 24a-25a).

To be cognizable for purposes of the "all events" test, a right or liability must be enforceable in some way, by

someone, at some time. This Court has held that "the term 'right,' certainly when used in a tax statute, must be given its normal and customary meaning . . . [A] 'right' [that is] neither ascertainable nor legally enforceable [is] not a right in any normal sense of that term." *United States* v. *Byrum*, 408 U.S. 125, 136-37 (1972) (estate tax). Treasury Regulations likewise make clear that a liability must be "based upon a valid and enforceable obligation to pay." Treas. Reg. § 1.166-1(c) (bad debt deductions). The Internal Revenue Service, at least until the district court decision in *Flamingo*, consistently interpreted the Treasury Regulations to condition accrual of income and deductions on the existence of enforceable rights and obligations. Indeed, the Government conceded before the Tax Court in this case that the unenforceability of gambling IOU's "presents a contingency which precludes accrual of income under the all events test of Treas. Reg. § 1.446-1(c)(1)(ii)." (App. D, *infra*, 27a).[1]

[1] After the district court decision in *Flamingo*, the Government abandoned its longstanding interpretation of the "all events" test and now contends that accrual of income can be required on the basis of an inherently unenforceable obligation. The cases relied upon by the Government to support its new position are inapposite. *See* Memorandum for the United States in Opposition, *Hilton Hotels Corp.* v. *United States*, No. 82-404, at 3-5. Most of these cases involved a right to income that was not *presently* enforceable; each taxpayer, however, had a fixed right to income—established by an Act of Congress, a final court judgment, a Government agency award, or a valid contract—that would become enforceable with passage of time. *See Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 295 (1932); *Automobile Insurance Co.* v. *Comm'r*, 72 F.2d 265, 268 (2d Cir. 1934); *Travis* v. *Comm'r*, 406 F.2d 987 (6th Cir. 1969). This Court's decisions make clear that a right to income need not be *presently* enforceable to generate accrual under the "all events" test, provided that the right exists and will become enforceable eventually. *See Comm'r* v. *Hanson*, 360 U.S. 446, 464 (1959).

Gambling IOU's incurred in Nevada are incapable of creating "fixed rights" or "unconditional liabilities" because they are absolutely void under state law. *See Flamingo Resort, Inc.* v. *United States*, 485 F. Supp. 926, 930 (D. Nev. 1980) (gambling IOU's under Nevada law "are void and not merely voidable"). A void instrument is "of no legal effect" and cannot provide the foundation for "any right of action." *California Nat'l Bank* v. *Kennedy*, 167 U.S. 362, 368 (1897).[2] Gambling IOU's incurred in Nevada are inherently unenforceable; they cannot be enforced in any way, at any time, by anyone, not even by a holder in due course. *Sandler* v. *District Court*, 614 P.2d 10 (Nev. 1980). Because a customer's payment of a gambling debt is entirely discretionary, an IOU cannot generate an "unconditional obligation" to pay on his part or a "fixed right" to receive payment on the casino's part.

By requiring casinos to accrue income before IOU's are actually paid, the Ninth Circuit has discarded the first element of the "all events" test—the requirement that there exist a "fixed right" to receive income.[3] For pur-

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[2] *Accord, e.g., Hirschfield* v. *McKinley*, 78 F.2d 124, 131 (9th Cir. 1935), *cert. denied*, 297 U.S. 703 (1936) (void contract "is one which never had any legal existence or effect"); *Cumberland Tel. & Tel. Co.* v. *Evansville*, 127 Fed. 187, 197 (D. Ind. 1903), *aff'd*, 143 Fed. 238 (7th Cir. 1906) (" 'void' means without legal efficacy; ineffectual to bind parties or to convey or support a right"); Corbin on Contracts § 7 (1963) (void promise "creates no legal relation of any kind").

[3] The Ninth Circuit in *Flamingo* relied heavily on *Barker* v. *Magruder*, 95 F.2d 122 (D.C. Cir. 1938), *followed in Barker* v. *United States*, 26 F. Supp. 1004 (Ct.Cl. 1939). Both decisions (which involved the same parties and facts) held that a voidable instrument represented a "fixed right to income." They required a creditor to accrue usurious interest in income prior to payment, even though the debt instrument was voidable under local law. Commentators early

poses of the "all events" test, the only relevant event in a gambling transaction—the only event capable of generating a "right," much less a "fixed right"—is the customer's payment. As the district court said in *Flamingo*, "the Nevada courts have consistently refused to recognize any legally enforceable rights arising out of a gambling transaction short of the actual transfer of money." 485 F. Supp. at 930.

In sum, because the decision below requires accrual in the absence of a "fixed right" or "unconditional liability," it is in serious conflict with this Court's decisions, with the Treasury's regulations, and with the Service's longstanding construction of those regulations.[4] The Government's

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recognized that these cases were aberrant. *See* Holland, *Accrual Problems in Tax Accounting*, 48 Mich. L. Rev. 149, 158 (1949) (concluding that, with exception of *Barker* cases, "the courts have evolved a definite requirement that legal liability must exist before accrual will be found proper"). The Internal Revenue Service itself had previously ruled that usurious interest should be accrued only when paid "inasmuch as the unpaid notes . . . are not legal obligations of the makers and are not collectible under due process of law." O.D. 1139, 5 C.B. 84 (1921). The *Barker* courts may have reached the correct result on the facts there involved: since the borrower and lender were controlled by the same person, there was some suggestion that the loan transaction was a sham. *See* Holland, 48 Mich. L. Rev. at 158. But the courts' reasoning was erroneous, just as the Ninth Circuit's reasoning was erroneous here.

[4] The conflict between the decision below and the Treasury's regulations goes beyond those sections that deal directly with accrual of income and deductions. Thus, Treas. Reg. § 1.166-1(c), which provides a deduction for bad debts or (in the alternative) for a reasonable addition to a reserve for bad debts, requires the existence of "a valid *and enforceable* obligation to pay a fixed or determinable sum of money." While the Ninth Circuit held gambling IOU's to be accruable, it did not, and could not, find them to be "enforceable obligations to pay." Petitioner is thus placed in the anomalous posi-

concession before the Tax Court that the voidness of gambling debts "presents a contingency which precludes accrual of income under the all events test" was not an isolated pronouncement. It was a restatement of the principles of existing law and reflected a position that the Service has taken consistently for the past fifty years. The Government's decision to abandon that position for the purpose of gaining revenues in this case is not sound tax administration and (as discussed below) entails ramifications far beyond the situation presented here.

2. The Decision Below Contradicts This Court's Decisions That Emphasize A Fundamental Distinction Between Tax And Financial Accounting.

In interpreting the "all events" test to require accrual of unpaid IOU's in income, the Ninth Circuit relied largely on casinos' past collection experience, which suggested a statistically high probability that gamblers would voluntarily discharge their debts. In *Flamingo*, the Court noted that customers in practice "usually pay up" and that Flamingo's "own estimates of collectibility on outstanding casino receivables" ranged as high as 96%. (App. E, *infra*, 34a-35a). The Court concluded that the casino under these circumstances had "a reasonable expectancy of collection;" its duty to accrue income depended not so much on whether it had the legal right to enforce collection "as upon the existing probability of its

tion of being required to accrue the IOU's in income, without being entitled (as are all other taxpayers) to a bad debt reserve for IOU's that can reasonably be expected to go bad. Although the Ninth Circuit suggested that petitioner should be entitled to some sort of offsetting deduction (*see* App. B, *infra*, at 23a), the Treasury's own regulations deny petitioner a bad-debt reserve, and the Government reiterated this position in the Tax Court.

being received." (App. E, *infra*, 33a, *quoting Barker* v. *Magruder*, 95 F.2d 122, 123 (D.C. Cir. 1938)).

By making "probability" and "reasonable expectancy" the standards for accrual under the "all events" test, the Ninth Circuit's decision contradicts a long line of decisions from this Court that emphasize the distinction between tax and financial accounting. In opinions spanning almost 50 years, this Court has repeatedly stressed that tax accounting demands certainty, not probabilities. In *Brown* v. *Helvering*, 291 U.S. 193, 200-01 (1934), the Court refused to permit deduction of a reserve for contingent liabilities, reasoning that the liabilities were not yet "fixed and absolute"; while "experience taught that there [was] a strong probability" that expenses would be incurred, "experience also taught that [the case did not involve] certainties." In *Thor Power Tool Co.* v. *Comm'r*, 439 U.S. 522, 543 (1979), the Court stated that "financial accounting . . . is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty." Recent Court of Appeals decisions echo these words, holding that tax accounting cannot tolerate "the uncertainty inherent in any method that relies on prognostications and assumptions about the future," even predictions that are "relatively scientific" or "reasonably accurate." *RCA Corp.* v. *United States*, 664 F.2d 881, 888-89 (2d Cir. 1981), *cert. denied*, 102 S.Ct. 2958 (1982).[5]

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[5] The reason for the different approaches of tax and financial accounting stems from their divergent goals. Financial accounting encourages the use of predictions and estimates because its purpose is to provide shareholders and creditors with a complete picture of the financial condition of the business as of year-end. Tax accounting, on the other hand, demands certainty because its goal is to fix a tax liability. *See Thor Power Tool Co.*, *supra*, 439 U.S. at 543.

Petitioner in this case properly included gambling IOU's in income for financial accounting purposes when the transactions took place because it had a reasonable expectancy of being paid. Collection of the IOU's, under relevant financial accounting principles, was "reasonably assured." AICPA, Accounting Research Bulletin 43, ch. 1A, ¶ 1 (1982). Probability of receipt, however, is insufficient to justify accrual under the "all events" test of tax accounting as construed in this Court's decisions. The "all events" test demands "fixed rights" and "unconditional liabilities." A mere probability of receiving a discretionary payment does not rise to the level of a fixed right to be paid.

3. The Decision Below Threatens The Treasury With Substantial Revenue Loss.

The Ninth Circuit's confusion of tax and financial accounting principles is not an academic or theoretical point. By making "probability" the criterion for accrual under the "all events" test, the decision threatens the Treasury with substantial revenue loss. It is well established that the "all events" test is symmetrical, *i.e.*, that it presents essentially the same standards for accruing income and deductions. *See, e.g.*, *Security Flour Mills Co.* v. *Comm'r*, 321 U.S. 281, 286-87 (1944); *Field Enterprises, Inc.* v. *United States*, 348 F.2d 485, 490 n.9 (Ct.Cl. 1965), *cert. denied*, 382 U.S. 1009 (1966); *Simplified Tax Records, Inc.* v. *Comm'r*, 41 T.C. 75, 79 (1963). If probability of receipt is sufficient to mandate accrual of income, probability of payment will likewise be sufficient to permit accrual of deductions, offering taxpayers the opportunity to take current deductions for estimated future expenses.

Taxpayers in the ordinary course of business set up reserves (shown as liabilities on their books) to cover

expenses and losses that can be expected to arise in the future. Manufacturers reserve for the estimated expense of performing warranty service on their products. *E.g.*, *Bell Electric Co.* v. *Comm'r*, 45 T.C. 158 (1965), *acq.*, 1966-2 C.B. 4. Shippers reserve for the estimated loss of cargo they transport. *E.g.*, *Gateway Transportation Co.* v. *United States*, 77-1 USTC ¶ 9131 (W.D. Wis. 1976). Employers reserve for the estimated cost of paying workmen's compensation claims. *E.g.*, *Thriftimart, Inc.* v. *Comm'r*, 59 T.C. 598 (1973), *acq.*, 1973-2 C.B. 4. Because there is a statistically high probability that these expenses and losses will occur, and because the amount to be reserved can be computed with a high degree of accuracy, additions to such reserves are deductible for financial accounting purposes. The decision below, with its "probability" analysis, threatens for the first time to permit deduction of these reserves for tax purposes as well.

A rough estimate of the revenue loss that could flow from acceptance of the Ninth Circuit's "probability" test can be gleaned from the legislative history of former Code section 462. Enacted in 1954, that section would have modified the "all events" test by permitting taxpayers to deduct reasonable additions to reserves for estimated future expenses. 26 U.S.C. § 462(a) (1954). The section was repealed retroactively the following year at the Treasury Department's request, after projections of the resulting revenue loss were raised from $47 million to over $1 billion. Pub. L. No. 84-74, ch. 143, 69 Stat. 134 (1955); H.R. Rep. No. 293, 84th Cong., 1st Sess. 3 (1955). Adjusted for inflation, that $1 billion revenue loss would be approximately $3.4 billion today.[6]

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[6] The inflation adjustment is based on the GNP Deflator. *See* Bureau of the Census, Historical Statistics of the United States, Pt. 1,

The logic of the decision below cannot be confined to cases involving gambling casinos, nor can it be confined to cases involving accrual of income rather than deductions. The ramifications of the Ninth Circuit's reasoning affect all accrual-basis taxpayers in the country and portend a serious challenge to the Treasury's equitable collection of revenue.

CONCLUSION

The petition for a writ of certiorari should be granted.

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May 6, 1983

at 1972 (1975); Bureau of the Census, Statistical Abstract of the United States 460 (1981); Office of Management and Budget, Budget of the United States, Fiscal Year 1984 at 2-9 (1983).

APPENDIX A

Desert Palace, Inc.,

Petitioner,

v.

Commissioner of Internal Revenue,

Respondent.

Docket No. 8531-74.

Filed September 11, 1979.

OPINION

Irwin, *Judge:* Respondent determined deficiences in petitioner's Federal income taxes as follows:

Year ended	*Deficiency*
Apr. 30, 1967	$461,793.32
Apr. 30, 1968	1,194,270.15
Apr. 30, 1969	3,019,061.24
Sept. 30, 1969	1,898,022.12
	6,573,146.83

The issues in this case have been severed and the one now presented for our decision is whether winnings from petitioner's customers who gamble on credit must be recognized as income at the time the receivable arises, or subsequently, when it is paid.

If we hold that petitioner must immediately recognize as income winnings from customers who gamble on credit, the parties have stipulated that petitioner is entitled to deductions under section 165[1] or section 166 as follows:

Taxable period ended	*Deduction*	*Taxable period ended*	*Deduction*
Apr. 30, 1967	$987,389	Apr. 30, 1969	$1,384,806
Apr. 30, 1968	1,489,932	Sept. 30, 1969	1,102,598

[1] All statutory references are to the Internal Revenue Code of 1954, as in effect during the years at issue.

However, we would then have to decide under which section petitioner is entitled to said deductions.

All of the facts relating to this issue have been stipulated. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Desert Palace, Inc. (hereafter DPI), is a Nevada corporation. DPI's tax returns for the taxable years ended April 30, 1967, 1968, and 1969 and the short taxable period ended September 30, 1969 (including an amendment on Form 1120X), were prepared on the accrual method.[2] The returns for the taxable years ended April 30, 1967 and 1968, were filed with the Office of Internal Revenue Service in Reno, Nev. The returns for the taxable year ended April 30, 1969, and the short taxable period ended September 30, 1969, were filed with the Office of the Internal Revenue Service in Ogden, Utah. The filing of a return for the short taxable year was due to the fact that Caesars World, Inc., acquired DPI in the summer of 1969.

DPI was located in Caesars Palace, a building situated on a portion of Las Vegas Boulevard South known as the "Strip."

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[2] By stipulating that DPI filed Federal income tax returns for the taxable periods ended Apr. 30, 1967, 1968, 1969, and Sept. 30, 1969, "on the accrual method," respondent does not agree that the accrual method was properly applied by DPI in computing its casino income. Respondent asserts that the manner in which petitioner treated accounts receivable arising from credit granted in the casino in computing its income for Federal income tax purposes was an incorrect application of the accrual method of accounting. The parties do, however, agree that in its Federal income tax returns for the period in question, DPI correctly applied the accrual method to all income and expense items other than (1) the items which are the subject of the petition in this case, (2) reserves, allowances, or deductions which may relate to items which are the subject of the petition, (3) items which may change because of the resolution of issues which are the subject of the petition, and (4) treatment of outstanding chips.

During the period in question, there were approximately 17 hotel-casinos located on or near the "Strip." Within Caesars Palace, DPI operated a hotel and various entertainment, restaurant, and bar facilities. In addition, firms not affiliated with DPI leased space in the building from which they sold various types of merchandise.

Under the laws of Nevada, a properly licensed firm or person may legally operate a gambling casino. During the entire period from August 1, 1966 (when DPI began is operations), to and including September 30, 1969 (the "period in question"), DPI held all licenses and permits necessary to enable it to operate the casino (hereafter Casino) at Caesars Palace Hotel & Casino (hereafter Caesars Palace) in Las Vegas, Nev., including an unrestricted license issued by the Nevada Gaming Commission (hereafter commission). During the entire period in question, DPI did, in fact, operate the Casino.

The principal games played in the Casino were blackjack, dice, roulette, and baccarat. In blackjack, dice and roulette, Casino customers would make bets using chips,[3] which would be redeemed at the cashier's cage (an area, similar to a tellers, area in a bank, which was adjacent to, and had an opening onto, the gambling area of the Casino) by the Casino for specified sums of money. In each of those games, if the customer won a bet, he would receive additional chips from the Casino, and if the customer lost a bet, the Casino would retain the chips bet by him. The odds on the bets which could be made at these games in most, if not all, instances favored the Casino. In baccarat, bets were made with cash. To the extent the Casino was able to control it, the cash which was used was bills which had been specially soaped to keep them from sticking together.

[3] After Apr. 1, 1968, a casino was prohibited by regulation 6.090 (subsequently regulation 6.100(1)) of the commission from playing these games for cash. Prior to that date the Casino, and most other casinos in Nevada, played these games with chips because use of chips made operation of the games easier.

Credit Operations

At all times during the period in question, as part of the normal and regular operation of the Casino, DPI extended credit to certain customers of the Casino. The magnitude of the gambling done on credit relative to the overall operation of the Casino is reflected in the following table:

Period ended	*Drop*[1]	*Total casino accounts receivable*[2]	*Receivable*[2] *received at tables other than baccarat as a percentage of drop*
Apr. 30, 1967	$67,501,453	$16,793,785	23%
Apr. 30, 1968	85,699,051	26,273,620	23.4%
Apr. 30, 1969	101,386,646	39,443,726	22.4%
Sept. 30, 1969	47,931,742	21,436,994	30.4%

[1] The "drop" for any given period was the cash and IOU's (represented by credit slips) taken in by any table, group of tables, or the Casino for that period.

[2] Not including accounts receivable represented by IOU's redeemed by customers during or at the conclusion of play.

Gaming activities in the State of Nevada are regulated by the commission and the Nevada Gaming Control Board (hereafter board). The commission from time to time promulgates formal regulations relating to gaming. During the portion of the period in question prior to April 1968, although regulation 6.030-1(c) and (g) referred to accounting for uncollectible casino accounts receivable, the regulations of the commission did not specify the procedures which should be used by casinos in connection with "credit play." In April 1968, the commission adopted regulation 6.043 governing procedures for "credit play" at various types of gaming establishments, and from that time to the end of the period in question, "credit play" procedures at the Casino were governed by that regulation.

Regulation 6.043 provided five alternate procedures for granting credit in a casino such as the Casino. These procedures were based upon procedures in use in various casinos at the time regulation 6.043 was originally adopted.

The Casino utilized the following authorized "credit play" procedure (regulation 6.043, par. 3) for baccarat during the period in question: A serialized record would be kept in the game area. All credit transactions involving each player would be kept on that form or in conjunction with a table card which would contain all or a portion of the required information. The required information would be when, where, and in what amount credit was extended. At the end of the shift, accounting day, or other period of time, when play was ultimately concluded by the player, an accounting would be made at the cashier's cage for any indebtedness; that indebtedness would be evidenced by a check or IOU,[4] and a credit slip would be sent to the table.

The Casino utilized the following authorized "credit play" procedure (regulation 6.043, par. 4) for games other than baccarat: A pre-numbered master card would be maintained in the pit area (a grouping of gaming tables) a representative of the auditing department. The master card would show the name of the player receiving credit and when, where, and in what amount credit was granted. A separate master card would normally be used for each shift. The master card would be supported by a "table card" maintained by the boxman or dealer at each table. The table card would show the name of each player receiving credit and the amount of credit given. The pit boss who authorized a credit would prepare a signed "receipt" in the form of an "advance card," "counter-check," "marker," or "IOU" and would make every reasonable effort to obtain the player's signature on the receipt. The information on the receipt would immediately be transcribed on the master card. If during the course of play or at the end of play, a player

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[4] An IOU signed by a customer in the Casino was in the form of a counter check (i.e., a check form with the name of the bank and the account number left blank). If the Casino inserted the name of a customer's bank and named itself as payee, the IOU could be presented for payment as a check drawn on the customer's bank.

paid with cash or chips all or a portion of the sum he owed, the pit boss would return an appropriate amount of customer-signed receipts and the amount and nature of payment would be noted on the master card and the table card. When a player completed playing, any balance due, which would be represented by checks, advance slips, or similar receipt forms, would be delivered to the cashier who would send a credit slip to the table. Notation would be made on the master card and on the table card that settlement had been made at the cashier's cage, and the credit slip would be dropped in the box.

The "credit play" procedure used at the Casino during the period in question was identical both prior and subsequent to the adoption of regulation 6.043. Although the "credit play" procedures at the Casino during the period in question were not invariable (exceptions having been made from time to time to meet the desires of particularly valued customers, and changes having been made in the prevailing procedures, resulting primarily from improved technology), the procedures with regard to the vast majority of transactions at the Casino were identical throughout the entire period in question.

When a typical customer first requested credit at the Casino, he was required to provide the credit manager information which would enable the credit manager to verify the credit worthiness of the customer. This information typically consisted of the names of the customer's principal banks and a statement of the maximum amount the customer wished to gamble. Before granting credit, DPI would verify with the customer's banks the customer's normal balances and would inquire of a Las Vegas information clearing service whether the customer had a history of paying, or refusing to pay, gambling debts.

Once the credit check was completed, the customer would be permitted credit up to a specified maximum amount, which would be dependent upon the result of that check and the credit limit requested by the customer. Thereafter, if the customer wished to gamble at the Casino, he could obtain on credit chips

(or, if he was a baccarat customer, cash in the form of bills which had been rubbed with soap) up to the amount of his credit limit, plus such additional amounts as the Casino executives in charge might from time to time authorize.

Once a customer was authorized to receive credit, it could be obtained either at gambling tables or at the cashier's cage. If a customer requested credit at a table, he was given chips (or soaped bills at the baccarat tables) in the requested amount, up to his credit limit. At the time of each extension of credit, the amount of the credit would be noted in a master book maintained in the area of the Casino where the customer was playing and on a card at the table at which he was playing. Also, at the time of each extension of credit, the customer would execute an IOU evidencing the extension of credit. Typically, each request for credit and each corresponding IOU, would be for a sum which was relatively small in relation to the customer's credit limit. If the customer lost the chips and wanted to continue play, he would request additional credit and execute additional IOU's.[5]

A customer's IOU's would be held in the Casino area either until the customer finished play at the particular group of tables at which the credit was extended (i.e., in the dice area or in the blackjack and roulette area) or until a shift changed, or, on particularly busy days, until the end of the day. At that point, the customer's IOU's would be transferred to the cashier's cage. If a customer with an outstanding IOU still had chips when he completed play, an effort, consisting of a request by an employee in the area of the Casino in which the customer

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[5] Extensions of credit to a customer at the baccarat table were recorded with buttons placed on the table until the customer left the table. They were also recorded on a master card in the baccarat area. The customer did not sign IOU's while he was playing. When the customer left the table, he would sign an IOU evidencing the outstanding balance of the credit granted to him while he was playing.

had been playing, and sometimes other Casino executives as well, was made to have the customer apply the chips toward a portion of his outstanding IOU's. In some instances, when a regular customer was staying at Caesars Palace for several days, no effort was made to have the customer apply his chips to redeem his IOU's until his stay was ending, but an effort was made at that time. The efforts to have chips applied to redeem IOU's were successful in most, but not all, instances. Therefore, with regard to most customers, the aggregate outstanding IOU's when the customer terminated play, or his stay, would be approximately the same as his net loss during the period of play or the stay. In some instances, a customer who had several outstanding IOU's when his play, or his stay at Caesars Palace, was completed would be asked to execute a new IOU in the total amount of the indebtedness and exchange it for the several IOU's he had previously issued.

When a table transferred IOU's to the cashier's cage, the cage would note receipt of the IOU's on an IOU control sheet (a sheet showing, with regard to each shift, all IOU's received in the cage and all IOU's held in the cage which were paid). The cage would also issue to the table a credit slip in the amount of the transferred IOU's.[6] For the management control purpose of determining the efficiency of particular tables, and as required by regulation 6.043 of the commission, this credit slip would be inserted in the "drop" box and included in the revenues of the table. However, for the purpose of determining the win of the Casino as a whole, all items at the table were transferred to the cage at or near the end of each shift (money having been counted in a count room before being delivered to the cage), and the win (or loss) of the Casino was the difference between the chips, cash, and IOU's in the Casino at the beginning of the shift and the chips, cash, and IOU's in the Casino at

[6] Copies of each credit slip were retained by the cashiers and by the accounting department and became a permanent record of the Casino.

the end of the shift. This win for the Casino as a whole represented the total Casino revenue for the shift.[7]

If credit was granted at the cashier's cage, the customer would be given chips (or bills for baccarat), and would be required to sign an IOU. No entry was made in a master book or on a table card in the Casino area, and, because there was no transfer of IOU's from the tables to the cashier's cage, no credit slip was issued. Rather, receipt of an IOU was recorded directly on the IOU control sheet maintained in the cage.

During the period in question, 77.63 percent of the credit transactions in the Casino involved credit issued at tables, and 22.37 percent involved credit issued at the Casino chashier's cage. Of the transactions involving credit granted at the Casino cashier's cage, 43.24 percent of those transactions (9.67 percent of the total credit transactions) involved issuances of credit to specifically identifiable customers who were known to employees of the Casino and who DPI believed it could demonstrate obtained chips or cash on credit for gambling purposes.

As frequently as practicable when credit was extended at the Casino cashier's cage, particularly when the customer requested more than minor amounts of cash, a Casino employee would be called to the Casino cashier's cage, and that employee would attempt to escort the customer to a gambling table. Also, the Casino cashier's cage would not issue significant amounts of cash to customers on credit unless the customers were known to be active baccarat players.

There were occasional deviations from the usual credit procedures (all of which DPI believes were permitted by regula-

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[7] In computing the net income of DPI for book and tax purposes, entries were made to reflect factors believed by DPI to relate to the ability to collect the accounts receivable evidenced by the IOU's (a reserve for book purposes, and elimination until collection for tax purposes). These entries were made, however, after Casino revenues were recorded.

tion 6.043). For example, some customers disliked having to sign IOU's when they were playing games other than baccarat. For some of those customers, unsigned IOU's were prepared and held in the Casino area until the customer completed play, at which time the customer would be asked to execute IOU's evidencing his entire credit balance then outstanding. Deviations from the usual credit procedures in the Casino occurred in only a small percentage of the total transactions at the Casino (both in number and dollars involved). Efforts were made by DPI to minimize the number of transactions in which there were deviations from normal credit procedures.

No interest was charged by DPI on outstanding Casino account receivable balances and these balances were not secured.

Nevada Law

A debt incurred for gambling purposes is not enforceable in the courts of Nevada, nor is it enforceable in the courts of any State of the United States. However, in an action for collection, the debtor must raise the defense that the debt was incurred for that purpose. This applies both to the Casino and the customer. In other words, the obligation of a Nevada casino to redeem chips issued to, or won by, customers also is not enforceable in the courts of Nevada or in the courts of any State of the United States.

The Supreme Court of Nevada has held that a debt incurred with credit granted at a gaming table while play is in progress is presumed to be a debt incurred for gambling purposes, and the courts of Nevada have without exception refused to enforce a debt of that type. There is no such presumption as to whether a debt arising from credit granted at a Casino cashier's cage is a debt incurred for gambling purposes. A person attempting to assert that such a debt was incurred for gambling purposes will have the burden of proving that the sums advanced were in fact used for gambling purposes.

In some instances, as part of its collection efforts, DPI has sued people who owed it money as a result of gambling transac-

tions, and the people have failed to assert that the debt was incurred for gambling purposes. In some of those instances, DPI has obtained judgments against the people who owed it money. DPI has never obtained a judgment against a person who demonstrated that the debt in question arose from a gambling transaction. However, notwithstanding a valid defense to the enforcement of the IOU's, DPI's collection rate on the IOU's was close to 95 percent.

At all times during the period in question, it was the position of the board that any casino which failed to redeem chips issued by it was operating in an unsuitable manner, as that term is used in regulation 5.010 of the commission. This could lead to disciplinary action, including a fine or suspension or loss of the casino's license to conduct gambling operations.

During the period in question, a chip issued at the Casino, or at other casinos in Nevada, would be exchanged by most casinos for their chips and accepted as payment by many merchants in Nevada, including those in Caesars Palace. Those chips would then be redeemed from the other casino or the merchant by the issuing casino. Subsequent to the period in question, many casinos in Nevada stopped accepting chips issued by other casinos in exchange for their own chips, and most, if not all, merchants stopped accepting chips in payment for merchandise.

Outstanding Receivables

When a customer completed play, or terminated his stay at Caesars Palace, the customer would be asked when he intended to pay the IOU's. If the customer indicated a specific date, his IOU's would be held by DPI until the specified date, at which time the date would be inserted on the IOU and DPI would deposit the IOU with its bank for presentation through the banking system for payment by the customer's bank (the names of the bank and of the payee having been inserted on the IOU's), or the IOU would otherwise be presented to the customer for payment in the manner requested by the customer. If a customer did not specify a date, DPI would immediately

deposit his IOU with DPI's bank for presentation through the banking system for payment by the customer's bank.

With regard to most IOU's, DPI treated the IOU as paid (debiting cash and crediting accounts receivable) and DPI's bank gave DPI credit for the amount of the IOU, when the IOU was deposited with DPI's bank. In some instances, however, DPI did not treat an IOU as paid, and DPI's bank did not give DPI credit for the amount of the IOU, until DPI's bank had been informed that the customer's bank had accepted and paid the IOU. If an IOU which was treated as paid when it was deposited was returned unpaid, DPI's bank would debit DPI's account for the amount of the IOU, and DPI would resume treating the IOU as an account receivable (crediting cash and debiting accounts receivable).

In some instances, a customer would give the Casino a personal check when he completed play. If the customer did not ask that his check be held uncashed, the check would be treated as immediate payment, subject to collection. If, however, a customer asked that a check be held uncashed for a period (at which point the check was called a "hold check"), or a personal check was returned unpaid (at which point the check was called a "returned check"), the check would be treated as an IOU for all purposes. The Casino accounts receivable of DPI at any point of time consisted of all outstanding indebtedness to DPI at that point of time evidenced by IOU's, including hold checks and returned checks, issued in connection with extensions of credit in the Casino.

If a customer did not pay his IOU's within a reasonable period of time, Casino personnel would contact the customer by telephone or in person on one or more occasions, and attempt to obtain payment. If that failed, unless there was a reason (such as death or bankruptcy of the customer) that the Casino decided it would not be fruitful to pursue the customer further, the IOU would be sent for collection to an attorney or collection agency where the customer resided. Although the fact that an IOU (including a personal check) was issued in

connection with a gambling transaction was an absolute defense available to the customer, in many instances the attorney or collection agent was able to collect the amount evidenced by the IOU, either because the customer paid it voluntarily or because the customer failed to assert the defense that the debt was incurred for gambling purposes. If the efforts of the attorney or collection agent were not successful, the IOU would be returned to the Casino. Thereafter, either Casino employees would continue to attempt to collect the sum represented by the IOU, or a decision would be made by the management of the Casino that the IOU was uncollectible.

Records were maintained by DPI for each customer showing the amount of all outstanding IOU's from the customer and indicating the efforts made to collect those outstanding IOU's.

Accounting Practices

The revenue from the Casino included by DPI for Federal income tax purposes in its gross revenue for a given period was the difference between the cash and chips on hand in the Casino at the beginning and at the end of the period (treating all Casino cash deposited in banks or used for non-Casino purposes as being on hand). Casino accounts receivable were not taken into account in determining income for tax purposes. As a result of this mechanism, DPI did not treat revenues from "credit play" as taxable revenue until the accounts receivable were actually collected. At the time an account receivable was collected, the proceeds of the collection were added to the cash on hand, and thus the full amount of the proceeds of the collection of that account receivable was treated as taxable revenue by DPI.

The table on p. [14a] illustrates the accounts receivable balances of DPI throughout the period in issue and, in addition, indicates the balances of these accounts receivable remaining outstanding as of July 31, 1975.

Casino Accounts Receivable

	Total received during period ended	Apr. 30, 1957	Apr. 30, 1968	Apr. 30, 1969	Sept. 30, 1969	July 31, 1970	July 31, 1971	July 31, 1975
Apr. 30, 1967								
IOU's and hold checks	$16,793,785							
IOU's and hold checks uncollected		$2,431,447	$913,131	$799,973	$785,650	$772,290	$763,760	$759,590
Returned checks uncollected		304,484	257,131	244,964	238,689	236,749	234,064	227,799
Subtotal			1,170,262	1,044,937	1,024,339	1,009,039	997,824	987,389
Total Casino receivables uncollected Apr. 30, 1967		2,735,931						
Apr. 30, 1968								
IOU's and hold checks	$26,273,620							
IOU's and hold checks uncollected			3,541,074	1,298,189	1,235,504	1,179,884	1,154,284	1,136,671
Returned checks uncollected			473,545	402,065	384,124	373,044	364,360	353,262
Subtotal			4,014,619	1,700,254	1,619,628	1,552,928	1,518,644	1,489,933
Total Casino receivables uncollected Apr. 30, 1968			5,184,881					
April 30, 1969								
IOU's and hold checks	$39,443,726							
IOU's and hold checks uncollected				4,419,754	1,729,655	1,190,890	1,103,800	1,067,583
Returned checks uncollected				399,912	355,311	340,607	331,430	317,225
Subtotal				4,819,666	2,084,966	1,531,497	1,435,230	1,384,808
Total Casino receivables uncollected Apr. 30, 1969				7,564,857				
September 30, 1969								
IOU's and hold checks	$21,436,994							
IOU's and hold checks uncollected					4,640,492	1,434,534	1,035,426	969,286
Returned checks uncollected					198,470	153,433	140,513	133,313
Subtotal					4,838,962	1,587,967	1,175,939	1,102,599
Total Casino receivables uncollected Sept. 30, 1969					9,567,895			

The revenue from the Casino included by DPI for financial statement purposes (as opposed to income tax purposes) in its overall revenue for a period was the difference between the cash, chips, and accounts receivable, net of a provision for doubtful accounts, on hand in the Casino at the beginning and at the end of the period (treating all Casino cash deposited in banks or used for non-Casino purposes as being on hand). The provision for doubtful accounts represented the estimate of the management of DPI of the ultimate amount of accounts receivable which would not be collected. That estimate was based primarily on an analysis by management or others of the collection history of the Casino, both with regard to its accounts receivable in general and with regard to specific customers. The accumulated provision for doubtful accounts, less write-offs of bad debts, was shown on the balance sheet of DPI as an allowance for doubtful collections.

The combined financial statements of DPI and an affiliated partnership which owned the real estate on which Caesars Palace is located for the fiscal years ended April 30, 1967, 1968, and 1969, were audited by Harris, Kerr, Forster & Co., certified public accountants. In accordance with generally accepted accounting principles, these financial statements included as an asset of DPI the Casino accounts receivable on hand, net of writeoffs and allowances for doubtful collections. Each of the audits by Harris, Kerr, Forster & Co., included a review of the adequacy of the allowance for doubtful accounts at the end of the fiscal year being audited. The combined financial statements of DPI and the partnership for each of those fiscal years were certified without qualification by Harris, Kerr, Forster & Co.

The income or loss of DPI reported on its Federal income tax returns for the taxable years ended April 30, 1967, 1968, and 1969 and its amended Federal income tax return for the short taxable period ended September 30, 1969, before net operating loss deductions, was as follows:

Year or period ended	Income (loss)	Year or period ended	Income (loss)
Apr. 30, 1967	($1,945,721)	Apr. 30, 1969	$4,439,581
Apr. 30, 1968	700,186	Sept. 30, 1969	(1,098,740)

At all times during the period in question, the State of Nevada imposed various license fees upon holders of gaming licenses. These fees included, with regard to the Casino and similar licensees, a quarterly fee based on gross revenues of the licensee. This fee was on a graduated basis, reaching 5½ percent of gross revenues in excess of $40,000. In computing quarterly gross revenues, a casino operator was permitted to include revenues from credit play in gross revenues or to exclude such revenues from gross revenues until the accounts receivable were actually collected.

In preparing its Federal income tax returns for the taxable years ended April 30, 1967, 1968, and 1969, DPI treated outstanding chips as liabilities, and therefore reduced taxable income for the year by an amount equal to any increase in the face amount of outstanding chips or increased taxable income by an amount equal to any reduction in the face amount of outstanding chips. In preparing its Federal income tax return for the short taxable period ended September 30, 1969, DPI did not treat outstanding chips as liabilities, although it had $64,668 in chips outstanding on that date. Therefore, taxable income for that period was increased by an amount equal to the face amount of chips outstanding at April 30, 1969. The face amounts of chips outstanding at April 30, 1967, 1968, and 1969 and September 30, 1969, and the amounts by which taxable income reported by DPI with regard to the taxable years or period ended on those dates was reduced or increased because outstanding chips were treated as liabilities at April 30, 1967, 1968, and 1969, were as follows:

Year or period ended	*Chips treated as a liability at end of year or period*	*Reduction or (increase) in taxable income for the year or period*
Apr. 30, 1967	$66,075	$66,075
Apr. 30, 1968	193,750	127,675
Apr. 30, 1969	127,712	(66,038)
Sept. 30, 1969	0	(127,712)

Because a holder of a chip may not enforce in the courts of Nevada or any other State of the United States, the obligation of a casino in Nevada to redeem outstanding chips, DPI concedes that, based upon its view of the law applicable to taxability of income from gambling transactions, it was not correct in treating the face amount of the chips outstanding at April 30, 1967, 1968, and 1969 as liabilities.

The issue in this case is the point at which DPI must accrue as income the receivables generated by customers who gamble on credit extended them by DPI, i.e., at the time they arise or when collected. Petitioner contends the application of accrual method accounting for tax purposes requires it not to recognize those receivables as income until collected. Respondent contends otherwise, asserting the receivables are income at the time the amounts they represent are won by the casino, notwithstanding the fact that they are subject to a complete defense in an action brought for their collection.

In support of its position of nonaccrual, petitioner emphatically argues that, with respect to the receivables in question, the "all events" test of section 1.446-1(c)(1)(ii), Income Tax Regs., and the judicial gloss thereon have not been satisfied. The all events test utilizes a two-prong test in order to determine if income should be accrued in any given taxable year. That test states "income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Sec. 1.446-1(c)(1)(ii), Income Tax Regs. Petitioner contends that while the second element of this test, that the item of income must be determinable with reasonable accuracy, has been satisfied, the first element, that all events have occurred which fix the right to receive the income, has not. Petitioners reasoning in support of this position is simply that gambling debts are unenforceable and since that unenforceability can be asserted as a complete defense to any action by petitioner for collection of the accounts receivable, all events necessary to fix the right to receive the income have not, in fact, occurred. Thus, petitioner argues, it acted

properly in not accruing the accounts receivable as income at any time prior to collection.

Despite the legalization of gambling by the State of Nevada, Nevada courts have steadfastly refused to enforce debts incurred for gambling purposes if the debtor has pled and proved that the debt was so incurred. *Scott* v. *Courtney*, 7 Nev. 419 (1872); *Evans* v. *Cook*, 11 Nev. 69 (1876); *Burke* v. *Buck*, 31 Nev. 74, 99 P. 1078 (1909) (Nevada Supreme Court held the debt instrument void); *Craig* v. *Harrah*, 66 Nev. 1, 201 P.2d 1081 (1949) (defendant failed to carry the burden of proof); *West Indies, Inc.* v. *First National Bank of Nevada*, 67 Nev. 13, 214 P.2d 144 (1950) (plaintiff-casino denied recovery of $86,000 in gambling debts); *Wolpert* v. *Knight*, 74 Nev. 322, 330 P.2d 1023 (1958) (defendant failed to carry the burden of proof as to four of the five loans involved). Nor are gambling debts incurred in Nevada enforceable in the courts of any other State in the United States (*Dunes Hotel & Country Club of Las Vegas* v. *Mayo*, 44 Misc. 2d 439, 354 N.Y.S.2d 62 (N.Y. County Civ. Ct. 1974)). A negotiable instrument issued as payment of a gambling debt has been held void by the Nevada Supreme Court (*Burke* v. *Buck, supra; Menardi* v. *Wacker*, 32 Nev. 169, 106 P. 287 (1909)).

Conversely, under Nevada law a casino is under no legal obligation to redeem chips issued to its customers or to pay wagers lost to its customers. *Weisbrod* v. *Fremont Hotel*, 74 Nev. 227, 326 P.2d 1104 (1958); *Corbin* v. *O'Keefe*, 87 Nev. 189, 484 P.2d 565 (1971); *Berman* v. *Riverside Casino Corp.*, 323 F.2d 977 (9th Cir. 1963).

Respondent agrees with petitioner that gambling debts are unenforceable under Nevada law. In a request for supplemental briefs, we posed the question:

> If the Court should reject respondent's theory that the accounts receivable in issue may properly be disassociated from the gambling transactions whereby the borrowed money was lost, should the taxpayer nevertheless be required to accrue the amounts represented thereby as income prior to the receipt of payment?

In briefing this question, the parties were to specifically consider:

(1) Whether the right which DPI has in the receivables is a legally enforceable right under applicable local law at the time the money represented by such borrowing is lost in gambling; and

(2) Whether legal enforceability of such receivables is a necessary ingredient of a fixed right to receive income from them.

In his supplemental brief, respondent stated:

> If the Court should reject respondent's theory disassociating casino accounts receivable from gambling transactions, the taxpayer should not be required to accrue the amounts represented [sic] casino accounts receivable as income prior to the receipt of payment, except to the extent of the casino receivables which were given to the casino at the cage.

Respondent agreed that petitioner's right to the receivables was not legally enforceable under Nevada law and that legal enforceability is a prerequisite to accrual under section 1.446-1(c)(1)(ii), Income Tax Regs.

Respondent's position favoring accrual of the receivables is not so straightforward. He does not deal with petitioner's argument favoring application of the "all events" test, but, rather, argues for application of what he denotes the "two step transaction" theory (step one being the loan transaction, step two being the gambling transaction). Using this theory, respondent would treat the winnings from customers who have received chips on credit the same as winnings from customers who have purchased chips with money borrowed from someone other than petitioner. In other words, respondent would have us deem irrelevant the fact petitioner also happens to be the lender in the loan transaction, thus arguing that the source of the credit used in obtaining the chips used to gamble has no effect on the requirement that DPI accrue as income its winnings from those customers gambling on credit.

Conceding that gambling debts are subject to the defense that they are not enforceable in an action to recover upon them, respondent attempts to isolate the issuance of chips or cash for the IOU from the gaming transactions which followed, asserting that the winning of chips or cash constitutes the totality of the income-earning process. The problem, as we see it, with respondent's analysis is that it is myopic.

The substance of a gambling transaction is the wagering of something of value on the fortuitous occurrence or nonoccurrence of certain events. In order to make the gambling casino administratively workable, at the time relevant herein, the casinos required that bets be made with chips (except in baccarat). Therefore, a party could not bet goods, services, cash (except in baccarat) or IOU's, although these could normally be proper subjects of a bet. The key is that chips (or cash in baccarat) stand in the place of these other items of value (specifically relevant to the case before us, the chips (or cash) stand in place of IOU's) to provide a uniform medium of exchange. Respondent concedes that if the IOU's were the actual subject of the betting, they would not be accruable. We believe, based on this concession, that the result is the same where the casino receives the IOU's and issues chips (or cash) in order that they be used as the medium of exchange. Expressed another way, we believe, based on respondent's concession,[8] that to the extent a customer's IOU to a casino would be treated by State courts as a gambling debt, and therefore unenforceable, it does not represent accruable income until paid.

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[8] The problems in this area may be more complex than perceived by the parties. See *Travis* v. *Commissioner*, 406 F.2d 987, 989-990 (6th Cir. 1969); *Barker* v. *Magruder*, 95 F.2d 122 (D.C. Cir. 1938); *Herberger* v. *Commissioner*, a Memorandum Opinion of this Court dated June 28, 1950, affd. 195 F.2d 293 (9th Cir. 1952). See also *Eastman Kodak Co.* v. *United States*, 209 Ct. Cl. 365, 534 F.2d 252 (1976).

A distinction exists, however, between IOU's issued at the gambling tables and those issued at the cages. Unlike table credit, cage credit does not carry a presumption of use for gambling purposes. *Burke* v. *Buck, supra; Craig* v. *Harrah, supra; Wolpert* v. *Knight, supra.* As stipulated by the parties and indicated in the findings of fact, 22.37 percent of the credit extended by the petitioner was cage credit. Petitioner bears the burden of proof that cage credit was actually used by borrowers for gambling. *Welch* v. *Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure. Petitioner's belief that it could demonstrate that certain customers obtained cage credit for gambling purposes does not, by itself, satisfy petitioner's burden of proof. Accordingly, petitioner must accrue the cage credit as income at the time of issuance.

An appropriate order will be entered.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 82-7091.

DESERT PALACE, INC.,
Petitioner/Appellee,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent/Appellant.

MEMORANDUM

Appeal from Decision of the
United States Tax Court

Argued and Submitted December 16, 1982
[Filed December 30, 1982.]

Before: MERRILL and FERGUSON, Circuit Judges, and GRANT,* District Judge.

The Commissioner of Internal Revenue appeals from a tax court decision holding that Desert Palace, Inc, a gambling casino, was not required to accrue accounts receivable generated by its extension of credit to patrons until such time as the amounts were actually paid. *Desert Palace, Inc.* v. *Commissioner*, 72 T.C. 1033 (1979). In its brief, appellee conceded that its case was on all fours with *Flamingo Resort, Inc.* v. *United States*, 664 F.2d 1387 (9th Cir. 1982), *rehearing & rehearing en banc denied*, April 2, 1982, wherein this court required accrual at the time the credit was extended.

However, Desert Palace contended that *Flamingo Resort* was wrongly decided and suggested *en banc* reconsideration. This suggestion was circulated to all active judges, none of

*Hon. Robert A. Grant, Senior United States District Judge for the Northern District of Indiana, sitting by designation.

whom called for *en banc* reconsideration. The suggestion was then referred to this panel, which has determined that *en banc* reconsideration is not appropriate; *Flamingo Resort* controls for the reasons stated in that opinion. We also reject Desert Palace's contentions that the *Flamingo* decision should not be applied retroactively as unpersuasive.

The decision of the tax court is therefore reversed and this matter is remanded to that court for determination of the question of whether the stipulated deductions to which the taxpayer is entitled as a consequence of this decision should be taken under Internal Revenue Code § 165 or § 166, an issue which that court did not reach because of its ruling in favor of the taxpayer.

REVERSED and REMANDED for proceedings not inconsistent with this disposition.

APPENDIX C

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 446. **GENERAL RULE FOR METHODS OF ACCOUNTING.**

(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

* * *

Sec. 451. **GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.**

(a) General Rule.—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * *

Sec. 461. **GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.**

(a) General Rule.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Treasury Regulations on Income Tax (26 C.F.R.):

Sec. 1.446-1. General rule for methods of accounting.

* * *

(c) *Permissible methods*—(1) *in general.*

* * *

(ii) *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be

determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.

* * *

SEC. 1.451-1. General rule for taxable year of inclusion.

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

* * *

SEC. 1.461-1. General rule for taxable year of deduction.

(a) *General rule—*

* * *

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

* * *

SEC. 1.166-1. Bad debts.

* * *

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.

APPENDIX D

UNITED STATES TAX COURT

Docket No. 8531-74

DESERT PALACE, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

SUPPLEMENTAL BRIEF FOR RESPONDENT

PRELIMINARY STATEMENT

This issue, which was severed by order of this Court of October 8, 1976, was presented without trial to Judge Leo H. Irwin on January 11, 1977. The evidence consists of a Stipulation of Facts and exhibits attached thereto (the Judge and Counsel for both parties observed the casino operated by Desert Palace, Inc.).

The court set the date for the filing of simultaneous Opening Briefs on or before March 28, 1977. On April 1, 1977, the Court granted the respondent's Motion to Accept Brief Out of Time. The respondent's Opening Brief was filed on that same date. The Court set the date for filing of simultaneous Reply Briefs 45 days after the filing of Opening Briefs. By Motion for Extension granted by the Court, Reply Briefs were due May 31, 1977. Reply briefs were timely filed.

On December 8, 1978, the Court ordered that the parties file with the Court simultaneous Supplemental Briefs on or before January 31, 1979, with simultaneous Reply Briefs to be thereafter filed on or before February 28, 1979. On January 24, 1979, the Court granted respondent's Motion to Extend the Time for Filing Supplemental Briefs to March 30, 1979.

A Rule 155 computation will be necessary in any event. It will, however, not be appropriate until the remaining issues are disposed of, either by mutual concession or by trial.

RESPONSE TO QUESTIONS POSED BY COURT

In its Order of December 8, 1978, the Court posed to the parties the following question:

> If the Court should reject respondent's theory that the accounts receivable in issue may properly be disassociated from the gambling transactions whereby the borrowed money was lost, should the taxpayer nevertheless be required to accrue the amounts represented thereby as income prior to the receipt of payment?

If the Court should reject respondent's theory disassociating casino accounts receivable from gambling transactions, the taxpayer should not be required to accrue the amounts represented [sic] casino accounts receivable as income prior to the receipt of payment, except to the extent of the casino receivables which were given to the casino at the cage. See respondent's Opening Brief, pp. 48 through 50.

The Court in its Order of December 8, 1978, asked two specific questions. In response to question (1): DPI's right in the casino receivables which resulted from credit granted for gambling purposes is not a legally enforceable right under the law of the State of Nevada at the time the money represented by such borrowing is lost in gambling nor at any other time.

In response to question (2): Legal enforceability of casino receivables is a necessary ingredient in determining when the petitioner's right to receive gambling income is fixed within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii). Under an accrual method of accounting, income accrues only when all the events have occurred which fix the taxpayer's right to receive such income. *United States* v. *Anderson*, 269 U.S. 422 (1926); *Spring City Co.* v. *Commissioner*, 292 U.S. 182 (1934). The unenforceability of the gambling debts receivables [sic] affects the accrual of income in that it presents a contingency which precludes accrual of income under the all events test of Treas. Reg. § 1.446-1(c)(1)(ii).

CONCLUSION

It follows that the determination of the Commissioner of Internal Revenue, except as modified herein, should be sustained.

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Mar 30 1979

APPENDIX E

FLAMINGO RESORT, INC.,
Plaintiff-Appellant,
v.
UNITED STATES OF AMERICA,
Defendant-Appellee.

No. 80-5318.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted Oct. 5, 1981

Decided Jan. 7, 1982

Rehearing and Rehearing En Banc
Denied April 2, 1982

Appeal from the United States District Court for the District of Nevada.

Before SNEED, TANG and PREGERSON, Circuit Judges.

SNEED, Circuit Judge:

The taxpayer, Flamingo Resort, Inc. (Flamingo), appeals from summary judgment by the district court in favor of the government. *See Flamingo Resort, Inc.* v. *United States*, 485 F.Supp. 926 (D.Nev. 1980). The action was instituted initially by Flamingo to recover monies, plus interest, paid by it pursuant to the assertion by the Commissioner of Internal Revenue (Commissioner) of a deficiency with respect to Flamingo's taxable period ending December 31, 1967.

Flamingo sought summary judgment with respect to that portion of the assessed deficiency that related exclusively to certain of the casino's receivables known as "pit markers." Flamingo's motion sought determination of the question of liability only, with the amount subject to later determination. The government also moved for summary judgment with respect to the entire amount in dispute.

The district court, after concluding that the one possible triable issue of material fact would be relevant only if legal enforceability of gambling debts was necessary for the accrual of the receivables in question, granted the government's motion for summary judgment on the ground that accrual was proper despite the absence of legal enforceability. We affirm.

I.

FACTS

The facts are set forth in detail by the district court in its opinion. 485 F.Supp. at 928-30. Briefly, they are as follows. Flamingo is a legal, licensed, gambling casino operating in the State of Nevada. The casino, an accrual basis taxpayer, excluded $676,432.00 of casino receivables in its 1967 tax return. The Commissioner required the accrual of these receivables and authorized an operating reserve fund for bad debts of $130,721. He then assessed a tax deficiency in the amount of $261,942.65, plus interest.

The receivables in dispute arose from uncollected loans extended by Flamingo in the course of its business. In order to facilitate its gambling operations, Flamingo extended credit to some of its customers. That line of credit was proffered only after an extensive credit check of the patron was conducted by the casino. The customer would sign a "marker" signifying his liability for the sum loaned.[1] Approximately sixty percent of the casino's total play resulted from such credit extensions.

Extensive collection efforts were undertaken on behalf of Flamingo to receive payment of those outstanding casino receivables not repaid prior to the patron's departure. Flamingo's estimates of collectability of those receivables ranged as high as ninety-six percent. The extension of credit and high incidence of payment occurred despite the fact that Nevada

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[1] These markers resemble counterchecks and as such indicate to the maker a definite and binding obligation of repayment.

does not recognize the legal enforceability of gambling debts. *Corbin* v. *O'Keefe*, 87 Nev. 189, 484 P.2d 565 (1971).

II.

ANALYSIS

The time of reporting of income of accrual basis taxpayers is governed by the "all events" test. The origins of this test can be traced to *United States* v. *Anderson*, 269 U.S. 422, 46 S.Ct. 131, 70 L.Ed. 347 (1926). There the Supreme Court held a tax payment for sale of munitions was *deductible* only in the year the sale occurred and not the following year in which the tax was paid. The taxpayer had contended the tax could not be accrued as an expense prior to its assessment and due date. The Court, in rejecting that argument, found "that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it." *Id.* at 441, 46 S.Ct. at 134. This approach was subsequently adopted by the Treasury Department with respect to the accrual of income. "Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas.Reg. § 1.451-1(a). *See also* Treas.Reg. § 1.446-1(c)(1)(ii).

This case does not involve the question of "reasonable accuracy." Rather the issue is when does the right to receive the income which the "markers" represent become "fixed" for accrual purposes. Commentators and the courts have generally stated that the existence of a definite liability is a prerequisite to the accrual of any obligation. *See* 2 J. Mertens, *The Law of Federal Income Taxation* §§ 12.61-62, 12.66 (rev. ed. 1974); Holland, *Accrual Problems in Tax Accounting*, 48 Mich.L.Rev. 149, 152, 155-56 (1949) [hereinafter cited as Holland]; J. Chommie, *Federal Income Taxation*, (2d ed. 1973) § 83 at 237; *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 50 S.Ct. 184, 74 L.Ed. 668 (1930) (inasmuch as the vendee did not become unconditionally liable to the vendor for the purchase

price in a particular year, no income with respect to the sale accrued to the vendor taxpayer). *But see* Holland, *supra*, at 154 (noting that the extremely strict requirement of *North Texas Lumber Co.* has been relaxed considerably). Flamingo, relying on these authorities, contends that because the persons who gave the "markers" for gambling purposes had no legal obligation to repay the casino, the "markers" being void as a matter of law under *Evans* v. *Cook*, 11 Nev. 69, 75 (1876), the "liability" they represent was not "fixed." Rather discharge of the "liability" was contingent on the customer's volition. Therefore, Flamingo should not be required to accrue the "markers."

Flamingo also relies on *H. Liebes & Co.* v. *Commissioner*, 90 F.2d 932 (9th Cir. 1937). There the issue was when should a debt due an accrual basis taxpayer by the government be accrued. The debt was owed by the government as the result of litigation. This court stated:

> We may conclude that income has not accrued to a taxpayer until there arises to him a fixed or unconditional right to receive it. . . .
>
> The complete definition would therefore seem to be that income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.

Id. at 937-38.

The court held that the right was fixed immediately upon expiration of the time for appeal by the government from the judgment in favor of the taxpayer. At that point there was a reasonable expectancy that the claim would be converted into money even if the funds to satisfy the judgment had not been appropriated. Although *Liebes* clearly establishes that an obligation must be "fixed" and that there be a "reasonable expectancy" of the obligation being converted into cash or its equivalent, it did not hold that in *all* situations the existence of a legal liability to pay is a prerequisite to the existence of a "fixed or unconditional right" to receive payment.

Nor do we believe that this prerequisite universally exists. Support for this position is provided by the line of authority that originates in *Barker* v. *Magruder*, 95 F.2d 122 (D.C.Cir. 1938), a case involving a taxpayer-lender who charged a rate of interest that violated the usury statute of the District of Columbia. The court held that, despite the fact the statute prohibited the taxpayer from legally enforcing the recovery of any interest, the uncollected usurious interest was properly accruable. It stated, "[t]he correct answer, as we think, depends not so much, as appellants urge, upon the legal right to enforce collection as upon the existing probability of its being received." *Id.* at 123.

The taxpayer's course of dealing with its debtor was considered determinative in fashioning the definition of "fixed."[2] In doing so the *Barker* court can be seen as properly avoiding a rigid definition of the term "fixed" in order to be responsive to unique facts and practical considerations. *See C. A. Durr Packing Co.* v. *Shaughnessy*, 81 F.Supp. 33, 36 (N.D.N.Y. 1948), *aff'd per curiam*, 189 F.2d 260 (2d Cir.), *cert. denied*, 342 U.S. 850, 72 S.Ct. 78, 96 L.Ed. 641 (1951).

Barker addresses a problem analogous to that presented in this case. Both involve a taxpayer attempting, as the district court below aptly phrased it, to "shield its *unsanctioned* operations from the normal incidents of the United States tax laws." 485 F.Supp. at 938 (emphasis added). Flamingo attacks this characterization as both astonishing and wrong and argues

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[2] One commentator has taken the position that the case should be passed over as one departing from the general requirement of the existence of a legal liability prior to the accrual of income. He notes the lendor and obligor were both controlled by the same interest and thus "the presence of a legally enforceable obligation would not serve to increase the probability of payment." Holland, *supra*, at 158. The *Barker* court, however, considered the overall course of dealing between the parties, with the unity of interest being but one factor. *See Travis* v. *Comm'r*, 406 F.2d 987 (6th Cir. 1969), discussed *infra*.

that the casino's operations are sanctioned by law. This is not the point the district court was addressing. Its comments were directed at the unsanctioned activity of gambling debt *enforcement*, not to the day-to-day legally authorized gambling operations of the appellant. Gambling debt enforcement in Nevada in 1967 and usurious interest enforcement in the District of Columbia at the time of *Barker* were each confronted by a bar to the use of the courts. In neither case would the courts have been available to aid enforcement.

Flamingo here, as did the taxpayer in *Barker*, points to certain speculative and potential legal objections to payment available to its debtors. The practical answer emerges from the facts. Few, if any, debtors raise these objections and usually they pay up. Gambling is big business in Nevada. Flamingo and others lawfully engaged in gambling in Nevada who employ the accrual basis in tax accounting should not be permitted to distort that method of accounting merely because the State of Nevada chooses not to permit the use of its courts to collect gambling debts.

Barker does not stand alone. The Court of Claims followed it in a case involving the same taxpayer. *See Barker* v. *United States*, 26 F.Supp. 1004 (Ct.Cl.1939). The court stated that it was in complete accord with the reasoning of the D.C. Circuit and refused to bar the accrual of income. Another case is *Travis* v. *Commissioner*, 406 F.2d 987 (6th Cir. 1969). The case involved a statutory prohibition against the collection of monies due under an executory contract for services which have not been rendered. The taxpayer contended such a legal bar should prevent recognition of that income under the accrual basis of accounting prior to the rendition of the services. The court, citing *Barker* v. *Magruder*, 95 F.2d 122 (D.C.Cir. 1938), with approval, noted the Supreme Court in *Commissioner* v. *Hansen*, 360 U.S. 446, 79 S.Ct. 1270, 3 L.Ed.2d 1360 (1959), had chosen to employ the phrase "fixed right to receive" rather than "enforceable right to recover." It held that accrual was proper when the sums became due and payable even though the service for which the sums were to be paid had not been

performed. The *Travis* court believed the practical problems which would arise if legal enforceability were required necessitated such an interpretation.

We agree and, as did the court in *Travis, id.*, emphasize the fact that the taxpayer rarely had to resort to litigation to collect the sums owing to it. Flamingo, as noted earlier, conducted approximately sixty percent of its business through extensions of credit, and its own estimates of collectability on outstanding casino receivables ranged as high as *ninety-six* percent. The lack of legal liability did not interfere with Flamingo's operation and it is doubtful that legal enforceability of the "markers" would or could increase its recovery rate.[3] Under these circumstances, the obligations of Flamingo's patrons are as "fixed" as it is possible to be and, in fact, no less so than those of other businesses. Flamingo should not be heard to argue that it should be taxed differently from other legitimate businesses. Its inability to enforce its "markers" in court is not a sufficient burden to justify such a differential. The debts which the "markers" represent are, therefore, fixed; there is a reasonable expectancy of collection; and no contention has been made that the amounts cannot be determined with reasonable accuracy.[4]

Flamingo puts forth a plethora of cases in support of its contention that legal enforceability of a debt must exist prior to its accrual. These cases, however, are uniformly inapposite. They involve, as the district court correctly noted, factual circumstances not germane to the instant case. *See Flamingo*

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[3] *Cf.* Holland, *supra*, at 158 (analysis/critique of *Barker* v. *Magruder*, 95 F.2d 122 (D.C. Cir. 1938)), and *see* note 2, *supra*. *See also Barker* v. *Magruder*, 95 F.2d at 124, (court's emphasis on course of dealing as determinative of when income may be seen as fixed).

[4] The existence of an apparently sufficient reserve fund approved by the Commissioner under I.R.C. § 166(c) in conjunction with the available option of a bad debt deduction, I.R.C. § 166(a), operate to mitigate any legitimate economic hardship to the appellant taxpayer.

Resort, Inc. v. *United States*, 485 F.Supp. at 934.[5] We hasten to add what should be obvious, however. Nothing in this opinion is intended to suggest that legal enforceability is not relevant in determining when a right to income is "fixed" for accrual basis tax accounting purposes. We merely hold that under the circumstances of this case its absence is not controlling.

AFFIRMED.

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[5] Appellant does raise one case which squarely addresses the question now before us. *Desert Palace, Inc.* v. *Comm'r*, 72 T.C. 1033 (1979). The Tax Court ruled gambling debts were not accruable to a gambling casino until collected. The court, however, did so on the basis of the government's concession of that issue at trial, and astutely commented that the issue was more complex than the parties perceived, citing the *Travis* and *Barker* decisions, 72 T.C. at 1050 & n.8. No such concession was made in the case now before us. And even if such a concession was made by the government, we are not bound by a party's erroneous view of the law. We agree with the district court that the Tax Court holding should not be applied here.

Office - Supreme Court, U.S
FILED
JUN 1983
ALEXANDER L. STEVAS.
CLERK

No. 82-1811

In the Supreme Court of the United States

OCTOBER TERM, 1982

DESERT PALACE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
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v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner seeks review of the decision below that it was required to accrue into its income, for federal income tax purposes, accounts receivable generated by its extension of credit to patrons of its licensed Nevada gambling casino, even though the receivables were not enforceable under Nevada law because they were gambling debts.

The relevant facts were stipulated, and may be summarized as follows: Petitioner operated a licensed gambling casino in Las Vegas, Nevada (Pet. App. 2a-3a). As a regular part of the casino's business, petitioner permitted some of its customers to gamble on credit (*id.* at 4a-7a). A line of credit was granted only after the casino conducted an extensive credit check on the customer, including an inquiry of a Las Vegas information clearing service as to whether the customer had a history of paying, or refusing to pay, gambling debts (*id.* at 6a-7a). The customer executed an IOU in

the form of a counter-check to evidence the credit advanced (*id.* at 5a n.4). These IOU's represented between 22% and 30% of petitioner's receipts from gambling (*id.* at 4a). The IOU's that were not redeemed by the close of play were deposited for presentation through the banking system for payment by the customer's bank (*id.* at 5a n.4, 11a-12a). Some IOU's that remained outstanding were sent for collection to an attorney or to a collection agency where the customer resided (*id.* at 12a-13a). The courts of Nevada and of other states do not enforce a gambling debt if a debtor raises the defense, and establishes, that the debt was incurred for gambling purposes (*id.* at 10a-11a, 18a). The evidence showed that few, if any, of petitioner's customers raised that defense. As a result, petitioner was able to collect almost 95% of the IOU's (*id.* at 10a-13a).

Petitioner kept its books and prepared its federal income tax returns on the accrual basis of accounting. It did not, however, accrue into its income for tax purposes the accounts receivable that it set up on its books to reflect the IOU's outstanding (Pet. App. 12a-13a).[1] Instead, it reported the receivables as income only for the years in which the IOU's were paid (*ibid.*). On audit, the Commissioner determined that the receivables should be accrued into petitioner's income for the years in which they arose (*id.* at 17a). He accordingly determined deficiencies totalling $6,573,146.83 in petitioner's income tax for its tax years ending in 1967, 1968, and 1969 (*id.* at 1a).

Petitioner thereafter brought this suit in the Tax Court for redetermination of the Commissioner's deficiencies. The parties stipulated that if the receivables were held to be accruable, petitioner would be entitled to deductions in

[1]In contrast, on petitioner's financial statements the receivables were accrued as income, net of a provision for doubtful accounts (Pet. App. 15a).

specified amounts for the years in question for losses or for bad debts (Pet. App. 1a-2a). As a result of a concession by the Commissioner,[2] the Tax Court ruled that to the extent a customer's IOU to the casino would be treated by state courts as a gambling debt, and therefore unenforceable, the IOU did not represent accruable income until paid (*id.* at 20a-21a).

The court of appeals reversed (Pet. App. 22a-23a). It pointed out that petitioner conceded that this case was on all fours with *Flamingo Resort, Inc.* v. *United States*, 664 F.2d 1387 (9th Cir. 1982), cert. denied, No. 82-404 (Nov. 29, 1982), where the court had required accrual of such casino receivables at the time the credit was extended. There, the court found from the circumstances surrounding the creation and repayment of the receivables that they were in practical effect as fixed and determinable as possible and, in fact, no less fixed than the obligations incurred by customers of other businesses; that the amounts owed could be determined with reasonable accuracy; and that there was at

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[2]The Commissioner initially took the position in the Tax Court that the receivables were not gambling debts and that their treatment therefore was not affected by restrictions on the judicial enforcement of gambling debts (Pet. App. 18a-20a). In a supplemental brief, he stated that to the extent the receivables were gambling debts, the absence of legal enforceability would preclude them from being sufficiently fixed and definite to require their accrual into petitioner's income (*ibid.*). Before the Tax Court entered its decision, the Commissioner concluded that this concession was in error, and sought reconsideration of the Tax Court's opinion, in light of *Flamingo Resort, Inc.* v. *United States*, 485 F. Supp. 926 (D. Nev. 1980). There, the district court held that the receivables of another duly licensed Las Vegas casino that extended credit to its patrons in the course of its gambling business were accruable into income. The Tax Court, however, denied the Commissioner's motion for reconsideration. Thereafter, the Ninth Circuit affirmed the decision in *Flamingo Resort* (664 F.2d 1387 (1982)), and this Court denied certiorari *sub nom. Hilton Hotels Corp.* v. *United States*, No. 82-404 (Nov. 29, 1982).

least a reasonable expectation of collection (Pet. App. 35a). The *Flamingo Resort* court saw no reason to permit a casino owner lawfully engaged in gambling to defer recognition of its income because of potential legal objections to payment available to its debtors that did not interfere with its business and were seldom, if ever, raised (*id.* at 34a-35a). The court below adhered to its prior *Flamingo Resort* decison and concluded that it controlled this case (*id.* at 22a-23a).[3]

1. The decision below correctly held that petitioner was required to accrue into income the receivables generated by its extension of credit to patrons of its casino, less an appropriate allowance for losses or for bad debts. In so ruling, the court below adhered to its prior decison in *Flamingo Resort*. That decision is fully consistent with the decisions of this Court and of other courts that have required, in certain circumstances, the accrual of a right to income, or of a liability for an expense, even though the right was not legally enforceable. There is, accordingly, no more reason to grant certiorari here than there was in *Flamingo Resort*, in which this Court denied certiorari earlier this Term.

In *United States* v. *Anderson*, 269 U.S. 422 (1926), from which the "all events" test for the accrual of income and deductions derives, the Court held that a tax on profits from the sale of munitions was accruable (and hence deductible) by a taxpayer in the year in which the munitions were sold, and not the following year when the tax was assessed and first became a legally enforceable liability of the taxpayer.

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[3]Petitioner's suggestion that *Flamingo Resort* should be reconsidered was rejected by the panel and by all active judges of the court of appeals (Pet. App. 22a-23a). The court also rejected petitioner's contention that *Flamingo Resort* should not be applied retroactively. It therefore remanded the case for a determination whether the stipulated deductions for uncollectible accounts to which petitioner was entitled should be treated as losses under Section 165 of the Internal Revenue Code of 1954 (26 U.S.C. (& Supp. V)), or as bad debts under Section 166 (Pet. App. 22a-23a).

As the Court explained (269 U.S. at 441): "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."

In *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290 (1932), the Court reached the same result with respect to the accrual of income. There, income was paid to a taxpayer in 1923 as an award pursuant to Section 204 of the Transportation Act of 1920, ch. 91, 41 Stat. 460. Although the Court agreed with the taxpayer that in 1920 "no proceeding was available to compel an allowance [of the award], or to determine the elements which should enter into the calculation," it nevertheless held that the taxpayer's right to the award accrued when the Act became law in 1920. As the Court stated (286 U.S. at 295): "The right to the award was fixed by the passage of the Transportation Act." The Court thus rejected the taxpayer's argument that the lack of legal enforceability of a claim precluded its accrual for purposes of the "all events" test.[4] See also *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 184-185 (1934).

[4]A similar argument was presented by the taxpayers in *Schlude* v. *Commissioner*, 372 U.S. 128 (1963). There, the taxpayers contended that accrual was not required of amounts due and payable under the terms of an executory contract where the state law barred a suit for the enforcement of such amounts prior to the rendition of services. (*Schlude* v. *Commissioner, supra*, Petitioner's Br. 1962 Term, No. 80, at 16-18.) Without discussion of that contention, the Court ruled that accrual of that income was proper. It explained (372 U.S. at 137; emphasis in original; citation omitted): "For an accrual basis taxpayer 'it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income,' and here the right to receive these installments had become fixed at least at the time they were due and payable." See *Travis* v. *Commissioner*, 406 F.2d 987, 989 (6th Cir. 1969), where the same argument against accrual of unenforceable sums due under the terms of an executory contract was expressly rejected.

In accord with these decisions, the Treasury Regulations provide that for an accrual basis taxpayer such as petitioner, "income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treasury Regulations on Income Tax (1954 Code), Section 1.451-1(a) (26 C.F.R.); see Section 1.461-1(a)(2).

The decisions of the courts of appeals and the Court of Claims refute petitioner's contention (Pet. 6-11) that legal liability must always exist before accrual of an item of income or expense is proper. Legal enforceability is but one of the circumstances that bears on whether an income or expense is sufficiently fixed and ascertainable to be accrued. The decision below is therefore not in conflict with any decision or with the Treasury Regulations. None of the cases cited by petitioner (*ibid.*) holds that a right to income cannot be accrued unless it is legally enforceable.[5] Like this case, *Barker* v. *Magruder*, 95 F.2d 122 (D.C. Cir. 1938), involved a lender whose right to income was subject to a legal defense—in that case, the defense was that the rate of interest called for under the terms of a loan was violative of the anti-usury statute then in force in the District of Columbia. The court held that the interest nonetheless was accruable based on all the facts and circumstances. It stated "[t]he correct answer, as we think, depends not so much, as appellants urge, upon the legal right to enforce collection as upon the existing probability of its being received" (95 F.2d at 123). The Court of Claims reached an identical conclusion with respect to the accrual of usurious interest in *Barker* v. *United States*, 26 F. Supp. 1004 (1939).

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[5]Petitioner's reliance (Pet. 8) on *United States* v. *Byrum*, 408 U.S. 125, 136-137 (1972), is misplaced. This Court's statement there that the phrase "right * * * to designate" a beneficiary of property connotes a legally enforceable power was made with reference to whether a power over property retained by a decedent rendered the property includible in his estate under the estate tax. It has no bearing on whether petitioner's right to receivables was accruable in its income under the income tax.

Similarly, in *Automobile Insurance Co.* v. *Commissioner*, 72 F.2d 265, 268 (2d Cir. 1934), the court upheld accruability of wartime damages payable by the Mixed Claims Commission even though the taxpayer did not have, and might never have, any means to enforce collection of the award. And as we have noted (see note 4, *supra*), in *Travis* v. *Commissioner*, 406 F.2d 987 (6th Cir. 1969), the court held that the taxpayer was required to accrue amounts due to it on an executory installment contract even though under state law the right to receive the installments was not legally enforceable because they were for services that had yet to be rendered. The court observed that the course of dealing of the parties to the contract as well as the terms of the contract indicated that the parties regarded the taxpayer's right to receive payment to be binding. It therefore concluded that accrual of the payments was required despite the lack of legal enforceability when " 'the transaction * * * [was] viewed as a whole and in the light of realism and practicality' " (406 F.2d at 990, quoting *Commissioner* v. *Segall*, 114 F.2d 706, 709 (6th Cir. 1940), cert. denied, 313 U.S. 562 (1941)). See also *Eastman Kodak Co.* v. *United States*, 534 F.2d 252, 257 (Ct. Cl. 1976) ("The 'all events' test * * * looks to a liability that is so fixed that the fact of liability is certain and the amount thereof reasonably ascertainable, *although not necessarily legally enforceable*" (emphasis supplied)).

2. The court below correctly applied the appropriate tests for accrual to the facts of this case. All the events had occurred to fix petitioner's right to receive payment of its receivables when its patrons' gambling losses were reflected by the IOU's they executed. Only the actual receipt of the income, not the right to receive it, remained at all contingent. As the district court pointed out in *Flamingo Resort*, the right to income evidenced by such IOU's was for a sum certain, payable on demand or within less than 30 days (see 485 F. Supp. at 938.

Here, as in *Flamingo Resort*, the IOU's took the form of counter-checks, which indicated to the customer that their execution resulted in a binding obligation. They were collectible through normal banking channels unless the customer issued a stop payment order. The fact that the casino made use of these credit extensions as a regular, if not essential, part of its business, and that they were preceded by a detailed credit check on the customer, supported the existence of a reasonable expectancy of payment. Indeed, despite the limitations on judicial enforcement, petitioner's collection rate on its IOU's was close to 95% (Pet. App. 11a). It is therefore highly doubtful that legal enforceability of the IOU's would or could increase the rate of collection (see Pet. App. 34a-35a). In these circumstances, the court of appeals was amply justified in concluding that an absence of legal enforceability did not bar accrual of the receivables. Indeed, petitioner's argument that the "all events" test is not satisfied until actual payment occurs is tantamount to seeking cash basis treatment for its gambling winnings attributable to its extension of credit to customers even though it is an accrual basis taxpayer. It would in effect place casino owners on a hybrid system of accounting under which they would enjoy the dual benefits of deferring recognition of a part of their receipts while continuing to accrue all their expenses.[6]

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[6]As the court of appeals correctly recognized (Pet. App. 36a n.5), the Commissioner's concession (see page 3 note 2, *supra*) was not of controlling significance. At the outset of the case, he conceded that a lack of legal enforceability would prevent the accrual of certain of petitioner's receivables. But the Commissioner retracted this concession before the Tax Court entered its decision. Petitioner does not claim that its conduct of this suit was prejudiced by the Commissioner's change in position. At all events, as this Court has made clear on several occasions, the Commissioner is free to make such a change when he determines that his initial position is in error. See *Automobile Club* v. *Commissioner*, 353 U.S. 180 (1957); *Dixon* v. *United States*, 381 U.S. 68 (1965).

3. Finally, there is no basis for petitioner's contention (Pet. 11-15) that the decision below sanctions (to the jeopardy of the revenue) the deduction of expenses, or the creation of deductible reserves for expenses, based solely on a probability that the expenses will be incurred. Estimated liabilities that are contingent upon future events generally are not accruable for tax purposes even though they may be highly predictable in the aggregate. See *Brown* v. *Helvering*, 291 U.S. 193 (1934); *Nightingale* v. *United States*, 684 F.2d 611, 614-615 (9th Cir. 1982); cf. *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979). Nothing in the decision below departs from that principle.

Contrary to petitioner's argument (Pet. 6, 13), the decision did not require petitioner to accrue its IOU's into income simply because of a probability that they would be paid. Nor was petitioner's right to payment (as distinguished from the actual receipt of payment) contingent upon any event. See *Schlude* v. *Commissioner*, 372 U.S. 128, 137 (1963); *Commissioner* v. *Hansen*, 360 U.S. 446, 464 (1959). Instead, the court based its decision in this case on all of the facts and circumstances pertinent to petitioner's experience with respect to its gambling receivables that showed petitioner's right to payment to be fixed, unconditional, and binding (Pet. App. 34a-35a). Thus, in its prior *Flamingo Resorts* decision, the court took care to make explicit that it regarded legal enforceability as relevant to whether a right to income is "fixed" for purposes of accrual accounting. It held only that an absence of legal enforceability did not preclude the Commissioner from requiring the accrual of income under the circumstances obtaining in that case (*id.* at 36a). Accordingly, the court of appeals in this case properly adhered to the rule it previously established in *Flamingo Resorts*.[7]

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[7]In the instant case, the court of appeals instructed the Tax Court to determine on remand whether the stipulated deductions to which petitioner is entitled should be allowed under Section 165 of the 1954 Code

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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Solicitor General

JULY 1983

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as losses or under Section 166 of the 1954 Code as bad debts (Pet. App. 23a). It therefore remains to be determined whether, as petitioner argues now (Pet. 10-11 n.4), the Treasury Regulations under Section 166 deny it a bad debt deduction or a bad debt reserve for its uncollectible receivables. At all events, if it accrues its receivables into income for the years involved in this suit, it is assured of partially offsetting deductions for the same years under the one provision or the other.